



## The Seven Signs of a Changing Economy

**“What to look for, where to find it and what to do when you see trends changing!”**

As of May 2008

**Summary:** Our Seven Signs came up with 3 neutral, 3 negative and one volatile for May 2008. As the Seven Signs are listed in prioritized order it is clear that the most important sign, Personal Consumption Expenditures (PCE), is the lead sign for economic change and it is neutral. Between 2002 and 2007 real consumer expenditures grew at 3.1% per year. This compares to 3.5% annual growth in the 1990s and 4.2% annual growth in the 1980s. As approximately 73% of the U.S. economy is consumer spending, a decline in spending will tend to cause the overall economy to slow. Since PCE is still growing, I think we will soon see more positives in our overall economy.

Part of the PCE reduction can be related to lackluster real wage and salary income growth. More importantly is the effect on consumer spending from higher energy costs (auto and home), higher food costs, higher property tax and soon to be higher income taxes, after the reversal of the Bush tax cuts.

We will keep our eyes on economic Winter Warning Signs #1, Personal Consumption Expenditures, as this is the lynch pin between a pretty decent economy and one that could start to spiral down for an extended period.

I will continue investing defensively and conservatively while carefully watching these important indicators of a changing economy.

**1. Indicator:** Personal Consumption Expenditure Survey (PCE)

**Where to find it:** [www.bea.gov](http://www.bea.gov)

**What to look for:** Consumer spending drops for three consecutive months

(Neutral)

This key indicator of economic health is just hanging in there! Personal Consumption Expenditures did grow for April at a .2% rate. This nearly flat percentage growth does represent \$21.4 billion more dollars spent in April than March. March had increased .4% or \$44.7 billion dollars over February 2008. We are growing slowly, but growth is growth. We have seen month over month growth here each reporting period this year. I post this neutral as the rate of growth is relatively low.



## 2. Indicator: Institutional Money Flow

**Where to find it:** [www.wordenbrothers.com](http://www.wordenbrothers.com) or [www.barrons.com/convictionoftraders](http://www.barrons.com/convictionoftraders)

**What to look for:** Decreasing prices on high volume of large block trades

**(Volatile)** With a downward bias

The way data is reported from the various sources I pull from can cause “time frame” overlap. Current updates are for May 2008 yet we get the data in June, as the data collection and number crunch process takes a few days. However, Winter Warning Sign #2 is more “real time” and June appears to be concluding with a test of the early 2008 lows. This means prices down and volume up, a bearish combination! That said, I continue to think we will hold at these key support levels represented by the January and March 2008 lows. As volatile as it has been prudent purchases of quality investments, peppered with patience, could prove very wise right now!! Call me if you would like to discuss what sectors appear most attractive, 303-933-2107.

## 3. Indicator: Leading Economic Indicators (LEI)

**Where to find it:** [www.businesscycle.com](http://www.businesscycle.com) or [www.newyorkfed.org/research/global-economy/globalindicators.html](http://www.newyorkfed.org/research/global-economy/globalindicators.html)

**What to look for:** Trends down for three to four months

**(Neutral)**

The leading index increased slightly in May, following a small increase in April. The leading index has risen in the past two months. However, the number of components that are falling continues to be greater than the number of components that are rising over the last six months. Thus, I remain neutral but unlike last month the weakness among indicators appears to be widening!

## 4. Indicator: Employment rate and after-tax personal income

**Where to find it:** [www.bls.gov](http://www.bls.gov)

**What to look for:** A flattening, then downturn trend in non-farm employment with a flattening to decreasing after-tax income

**(Negative)**

In April 2008 the non-farm payroll was little changed at -20,000 following a job loss of 240,000 in the first three months of the year. Now in May we are reduced by another 49,000 jobs. Thus, each month this year has seen unemployment rise we now stand at 5.5% unemployment vs. last month's 5%. This is not a terrible number it just represents a trend that is less than positive and appears to be gaining momentum. The consumer can't spend much without a job and as we all know, consumer expenditures are 73% of the US economy. Thus, I would very much like to see this trend reverse. This now represents a negative trend!



Personal income increased .3% over the previous month. Same as last month. Sounds good, right? Well it represents an hourly earnings increase of \$.05/hour over the prior month! I know I can be a bit crusty but a \$.40 per day increase doesn't keep up with food and gas pump price increases. "Negative" comes to mind!

**5. Indicator:** Durable goods spending

**Where to find it:** [www.census.gov/indicator/www/m3](http://www.census.gov/indicator/www/m3)

**What to look for:** A decreasing trend, especially a downward trend of four to five months out of six

**(Negative)**

These long shelf-life items like non-perishable, non-fashion items are usually the first to show signs of a slowing economy. Remember, these are items we can do without, if need be. New orders, after revisions, are reported down in three of the last four months. Shipments were up for the month after two consecutive down months. Inventories increased again this month. Inventories are now up nine of the last ten months! Okay, shipments out are up a bit, but if new orders are down and inventories are up I must conclude the consumer is not buying durables. This is not good and we must watch this very closely!

**6. Indicator:** S&P 500 earnings per-share growth

**Where to find it:** [www.standardandpoors.com](http://www.standardandpoors.com)

**What to look for:** Two down quarters of S&P 500 earnings per-share growth

**(Neutral)**

1Q08 EPS is final at \$16.62/share versus \$15.22 for single digit gains. It makes no sense to mention "my opinion" of 2Q08 earnings until the data is in. That said, Financial Services earnings, which represent approximately 25% of the S&P 500, have been decimated. With energy and commodity prices rising consistently, I expect 2Q08 earnings to be flat to up slightly at best! Weak trend here so I will leave as neutral.

**7. Indicator:** Inflation/deflation numbers

**Where to find it:** [www.bls.gov/ppi/](http://www.bls.gov/ppi/) or [www.bls.gov/cpi/](http://www.bls.gov/cpi/)

**What to look for:** An interruption to the consistent but modest increase in the cost we all pay for goods and services

**(Negative)**

At a 4.2% year over year (YOY) inflation rate in the Consumer Price Index (CPI), I must confess doesn't sound like a "modest increase" as posted above in the Winter Warning Sign. President Gerald Ford created the WIN (Whip Inflation Now) buttons in October 1974 when the inflation rate grew past 4%. I don't need a button to tell when it smells like the mid-1970s and possible stagflation here!



According to Bureau of Labor Statistics of the U.S. Department of Labor the CPI increased .8 percent in May. As you might guess, the key components causing the increase were energy with an annualized increase of +28.2%, transportation with an annualized increase of +8.7% and food and beverages with an annualized increase of 5.9%. If energy backed off just a bit, and I think it will, this will be a good sign. Any backing off is likely to be short-lived. Therefore I continue to post this Winter Warning Sign as negative.